IT 99-14
Tax Type: Income Tax
Issue: Subpart F Issues

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 89-IT-0000** **FEIN: 00-0000000** **Tax yr.: 1984, 1987**
v.	
"ADIRONDACK TELECOM SYSTEMS CORPORATION" and Subsidiaries, **Taxpayers**	**Charles E. McClellan** **Administrative Law Judge**

RECOMMENDATION FOR DECISION

Deborah H. Mayer for the Department of Revenue. David A. Hughes of Horwood, Marcus & Berk for the taxpayer.

Synopsis:

This matter involves Notices of Deficiency ("NODs") issued by the Department to "Adirondack Telecom Systems Corporation" and affiliates ("taxpayers") at various times from June 6, 1989, through November 3, 1995. Originally, the years involved were the years ended December 31, 1982, 1983, 1984 and 1987. A pre-trial order was entered on June 18, 1998, setting forth the issues in the following terms:

> 1. Whether taxpayer, in conceding the issue that its Subpart-F income was subject to the Illinois Income and Replacement Tax for tax years ended 12/82 and 12/83, also conceded that issue for tax year ended 12/84, and
>
> 2. If taxpayer has not conceded the Subpart -F issue for 12/84, the only issue before this Administrative Hearing Division

> is whether taxpayer's Subpart-F income is subject to the Illinois Income and Replacement Tax for tax years ended 12/84 and 12/87.

On October 21, 1998, the parties filed a stipulation of fact in which taxpayers conceded the Subpart-F[1] issue for the 1982 and 1983 years. (Stip. ¶ 21) Both parties waived their rights to an evidentiary hearing. (Stip. ¶ 82)

My recommendation is that the NODs be made final.

Findings of Fact:

1. "Adirondack Telecom Systems Corporation" ("ATS") was incorporated under the laws of the State of "Someplace, USA" in 1900 and maintains it principal place of business in "Anytown", Illinois. Stip. ¶ 1.

2. "ATS" is engaged in the business of manufacturing, assembling and selling telecommunications equipment and maintains manufacturing facilities and sales offices in various locations throughout the United States. Stip. ¶ 2.

3. During the tax years ending December 31, 1984 and December 31, 1987, "ATS" was 100% owned by "Parent Corporation", which was in turn 100% owned by "Super Parent Corporation". Stip. ¶ 3.

4. "Super Parent Corporation", a "Someplace" corporation, is engaged in the business of providing local telephone services to locations throughout the United States. Stip. ¶ 4.

[1] Subpart F refers to Sections 951-964 of the Internal Revenue Code of 1986. The Internal Revenue Code of 1954, as amended, was in effect for the first year involved in this case. Amendments to that Act which resulted in the Internal Revenue Code of 1986, do not affect the provisions involved in this case, so for convenience, all references to Internal Revenue Code sections ("IRC") refer to sections of the Internal Revenue Code of 1986.

5. “Super Parent Corporation” timely filed U.S. Form 1120, Corporation Income Tax Return ("Federal Return"), for the 1984 and 1987 tax years on a consolidated basis including all domestic subsidiaries of which “Super Parent Corporation” owned 80% or more of the outstanding stock. Stip. ¶ 5.

6. Taxpayers timely filed their Illinois Corporate Income and Replacement Tax Returns (“Illinois Returns”) for the taxable year ended December 31, 1984 on a separate, combined basis. Stip. ¶ 7.

7. Taxpayers timely filed their Illinois Return for the taxable year ended December 31, 1987 on a single, combined basis. Stip. ¶ 9.

8. Taxpayers timely paid the tax shown due on their 1984 and 1987 Illinois Returns as filed. Stip. ¶ 12.

9. The Department audited the taxpayers' Illinois Returns as filed for the tax years ended December 31, 1982 through December 31, 1984 and December 31, 1987. Stip. ¶ 13.

10. On June 6, 1989, the Department timely issued Notices of Deficiency (“Notices”) to each of the taxpayers for the 1982 through 1984 tax years, proposing to assess additional tax and interest in the amount of $493,320. Specifically, Notices were issued to the following companies in the following amounts:

Company	FEIN	Deficiency Amount
“Subsidiary #1”	00-0000000	$1,598
“Subsidiary #2”	00-0000000	$2,837
“Subsidiary #3”	00-0000000	$1,186
“Subsidiary #4”	00-0000000	$231,802
“Subsidiary #5”	00-0000000	$636
“Subsidiary #6	00-0000000	$12,351
“Subsidiary #7 (ATS)”	00-0000000	$170,025
“Subsidiary #8	00-0000000	$5,992

Company	FEIN	Deficiency Amount
“Subsidiary #9”	00-0000000	$2,244
“Subsidiary #10”	00-0000000	$37,579
“Subsidiary #11”	00-0000000	$7,888
“Subsidiary #12”	00-0000000	$227
“Subsidiary #13”	00-0000000	$138
“Subsidiary #14”	00-0000000	$2376
“Subsidiary #15	00-0000000	$445
“Subsidiary #16	00-0000000	$1,147
GTE Lenkurt Incorporated	00-0000000	$516
“Subsidiary #17	00-0000000	$2,452
“Subsidiary #18	00-0000000	$4,291
GTE Directories Publishing Corporation	00-0000000	$1,424
“Subsidiary #19	00-0000000	$4,095
“Subsidiary #20”	00-0000000	$2,071
Total		$493,320

Stip. ¶ 15.

11. On November 3, 1995, the Department timely issued a Notice of Deficiency to taxpayers for the 1987 tax year, proposing to assess additional tax and interest in the amount of $359,704. Stip. ¶ 17.

12. In response to the Notices of Deficiency, taxpayers timely filed Protests and Requests for Hearing for the 1982-1984 and 1987 tax years. Stip. ¶ 19.

13. Subsequent to filing its protest for the 1982-1984 tax years, the taxpayers conceded the subpart F income at issue in this matter for the 1982 and 1983 tax years. With respect to subpart F income only, the 1982 and 1983 tax years are no longer in issue. subpart F income remains an issue for the 1984 and 1987 tax years. Stip. ¶ 21.

14. During the 1984 and 1987 tax years, "Super Parent Corporation" owned, directly or indirectly, 80% or more of the outstanding stock of the following companies which were controlled foreign corporations (CFCs") within the meaning of Section 957 of the Internal Revenue Code:

"CFC #1"
"CFC #2"
"CFC #3"
"CFC #4"
"CFC #5"
"CFC #6"
"CFC #7"
"CFC #8"
"CFC #9"

Stip. ¶ 22.

15. As a result of "Super Parent Corporation's" ownership of these CFCs, it reported "subpart F income" on Schedule C (line 9) of its consolidated Federal Returns for the 1984 and 1987 tax years pursuant to Internal Revenue Code Section 951(a)(1)(4)(ii). Stip. ¶ 23.

16. The actual amounts of subpart F income included in federal taxable income and reported on Schedule C (line 9) of the consolidated Federal Returns as filed by "Super Parent Corporation" for the 1984 and 1987 tax years are $68,483,451 and $73,213,454, respectively. Stip. ¶ 24.

17. The subpart F income that was reported on Schedule C (line 9) of "Super Parent Corporation's" consolidated Federal Return as filed for 1984 and 1987, was included in federal taxable income in such tax years pursuant to §§ 951(a)(1), 952 and 954. Stip. ¶ 72.

18. For the 1984 and 1987 tax years, "Super Parent Corporation" claimed foreign tax credits pursuant to Sections 901 et seq. of the Internal Revenue Code in the amounts of $51,619,533 and $26,601,096, respectively, to offset its federal income tax liability for the foreign taxes paid by the CFCs. Stip. ¶ 73.

19. On their 1984 and 1987 Illinois returns as filed, taxpayers claimed subtraction modifications of subpart F income totaling $56,203,063 and $72,904,454, respectively. These amounts represent only a portion of the subpart F income listed on Schedule C (line 9) of "Super Parent Corporation's" U.S. Forms 1120 as filed. Stip. ¶ 74.

20. In computing its subtraction modification for purposes of its Illinois Returns, the taxpayers excluded the subpart F income attributable to "CFC #7". and "CFC #8" because these companies are "80/20" companies that are excluded from taxpayers' Illinois unitary business group pursuant to 35 ILCS 5/1501(a)(27)[2]. For the 1984 tax year only, taxpayers reduced their Illinois subtraction modification for subpart F income by an additional 15% based upon taxpayer's understanding and interpretation of instructions contained on the IL-1120, Schedule J. Stip. ¶ 75.

21. The subpart F income amounts totaling $56,203,063, and $72,904,454, set forth above, represent income from CFCs that was included in "Super Parent Corporation's" federal taxable income on its 1984 and 1987 federal returns, respectively,

[2] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, et *seq.*, the Illinois Income Tax Act ("ACT").

as filed (Schedule C, line 9) pursuant to subpart F, Sections 951 et seq. of the Internal Revenue Code. Stip. ¶ 78.

22. During the 1984 and 1987 tax years, the CFCs made cash distributions from "previously taxed earnings and profits" (as defined by IRC §959(a)) as follows (Stip. ¶ 79):

Controlled Foreign Corp.	1984 Cash Distribution	1987 Cash Distribution
"CFC #1"	$30,300,000	-0-
"CFC #2"	-0-	$23,400,000
"CFC #3"	-0-	-0-
"CFC #7"	$2,062,000	$2,642,000
"CFC #8"	$105,000	$120,000
"CFC #4"	$34,922,000	$38,999,000
"CFC #5"	-0-	-0-
"CFC #6"	-0-	-0-
"CFC #9"	$2,885,000	-0-
Total	$70,274,000	$65,161,000

23. The full amounts of the cash distributions (set forth above, $70,274,000 and $65,161,000, respectively) to "Super Parent Corporation" in 1984 and 1987 were excluded from its federal taxable income for the 1984 and 1987 tax years because they were "previously taxed earnings and profits" under IRC §959(a).[3] Stip. ¶ 80.

24. In computing their 1984 and 1987 Illinois combined base income subject to apportionment, taxpayers did not take a subtraction modification under Section 203(b)(2)(N) (renumbered to Section 203(b)(2)(O)) for the distribution of previously taxed earnings and profits. Stip. ¶81.

Conclusions of Law:

The only issue remaining to be decided is whether taxpayer's Subpart-F income is subject to the Illinois Income and Replacement Tax for tax years ended 12/31/84 and

[3] In summary, "previously taxed earnings and profits", means income earned by a controlled foreign corporation that has previously been reported as Subpart-F income. IRC § 959(a).

12/31/87. This issue arose because the taxpayer claimed subtraction modifications for the amount of Subpart-F income it was required to report as income on its federal income tax returns for those years under IRC § 951. Taxpayer raises an alternative argument that the Subpart-F income is not taxable in Illinois because it is non-business income allocable to "Someplace, USA", the state in which taxpayer maintains its principal place of business.

Taxing statutes are to be strictly construed. Their language cannot be extended or enlarged by implication beyond its clear meaning. In cases of doubt they are constructed most strongly against the government and in favor of the taxpayer. Van's Material Co. v. Dept. of Revenue, 131 Ill. 2d 196, 202 (1989). Generally, in order to carry out legislative intent, tax statutes are to be construed reasonably without bias to the State or to the taxpayer. United Legal Foundation v. Department of Revenue, 272 Ill. App. 3d 666, 667, 650 N.E. 2d 1064, 1071 (1st Dist. 1995).

There is a distinction, however, in the construction of statutes imposing tax and statutes granting exemptions. Statutes imposing taxes are strictly construed in favor of the taxpayer and against the state so that the taxpayer is not deprived of his property by summary proceeding or by penalties or forfeitures. *Id.* at 677. However, it is well established that a statute which exempts property or an entity from taxation must be strictly construed in favor of taxation and against exemption, and that the exemption claimant must prove clearly and conclusively its entitlement. Wyndemere Retirement Community v. Department of Revenue, Ill. App. 3d, 455, 459 (1995). Additionally in analyzing an exemption, all facts are to be construed and all debatable questions resolved in favor of taxation. *Id.*

Section 201 imposes a tax on a corporation's net income for the taxable year. In the case of a corporation, Section 202 defines net income as a taxpayer's base income. The term "base income" for a corporation is defined in Section 203 as being taxable income for the year (as determined for federal income tax purposes) plus or minus the modifications specified in Section 203(b)(2). For the years at issue, Section 203(b)(2)(O) allowed a subtraction modification for dividends received by a corporation in the following terms:

> An amount equal to: (I) 85% of the amount by which dividends included in taxable income and received from a corporation that is not created or organized under the laws of the United States or any state or political subdivision thereof exceed the amount of the modification provided under subparagraph (H) of paragraph (2) of this subsection (b) which is related to such dividends; plus (ii) 100% of the amount by which dividends, included in taxable income and received from any such corporation specified in clause (I) that would but for the provisions of Section 1504(b)(3) of the Internal Revenue Code be treated as a member of the affiliated group which includes the dividend recipient, exceed the amount of the modifications provided under subparagraph (H) of paragraph (2) of this subsection (b) which is related to such dividends. 35 ILCS 5/203(b)(2)(O).

The first issue to be addressed is whether the Subpart-F income is non-business income, as taxpayer argues in the alternative. If it is non-business income, then the issue of whether taxpayer is entitled to a subtraction modification for the Subpart-F income becomes moot. The non-business income issue was not raised in taxpayer's protest nor was it listed as one of the issues in the pre-trial order. It was raised for the first time in taxpayer's post hearing brief.

The Department responded to this argument by filing a motion to strike this section (V. B., pp19-22) of the taxpayer's brief. This section of taxpayer's brief was stricken by order entered on February 1, 1999, because it was raised as an affirmative defense for the first time in taxpayer's post-hearing brief. Because the portion of taxpayer's brief arguing that the subpart F income is non-business income was stricken, the Department did not respond to it in its brief. Raising this defense for the first time in taxpayer's brief is clearly improper and proscribed by statute, 735 ILCS 5/2-613(d), and by regulation, 86 Admin. Code ch. I, § 200.120(b)(4).

However, even if this argument had not been stricken it would fail. The Department's *prima facie* case is established by the introduction into evidence of copies of its records under the certificate of the Director. 35 ILCS 5/914; Balla v. Dept. of Revenue, 96 Ill. App.3d 293 (1st Dist. 1981). Therefore, when the Department's records were introduced into the record, the Department's *prima facie* case that the taxpayer's Subpart-F income was apportionable business income was established.

A taxpayer's testimony alone will not overcome the Department's *prima facie* case. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987). To overcome the Department's *prima facie* case the taxpayer must present consistent and probable evidence identified with its books and records. *Id*. Regarding the issue of whether the subpart F income was business or non-business income, there are no documents or stipulations of record which overcome the rebuttable presumption of correctness created by the introduction into evidence of the Notice of Deficiency assessing it as business income. Taxpayer simply has failed to introduce any evidence to rebut the Department's *prima facie* case which treats the Subpart-F income as apportionable business income. Therefore, the categorization of the Subpart-F income as business income is presumptively correct.

With regard to the subtraction modification issue, for the years at issue, there was no subtraction modification in the Act for Subpart-F income, and, as the Department states in its brief, the only modifications allowed are those specified in the statute, which specifically prohibits modifications not specified in the statute. Section 203(h).

It is true that, in 1987, Section 203(b)(2)(O) was amended by P.A. 84-1455 to allow a subtraction modification for dividends received or paid or deemed paid under Sections 951 through 964 of the Internal Revenue Code. Sections 951 through 964 are the sections that make up Subpart-F of the Internal Revenue Code. However, Section 203(b)(2)(O) specifically provides that the Subpart-F subtraction modification applies only to years ending on or after December 31, 1988. Thus, under the clear language of the statute, there was no subtraction modification for Subpart-F income for the years at issue in this case, and as noted previously, Section 203(h) allows only those modifications that are specified in the statute.

Taxpayer's first argument is that Subpart-F income is a dividend for which it is entitled to claim a subtraction modification under Section 203(b)(2)(O). Taxpayer relies on Section 102 which provides that any term in the Act shall have the same meaning as when it is used in a comparable context in the IRC. IRC § 316(a), in relevant part, defines a "dividend" as being:

> [A]ny distribution of property made by a corporation to its shareholders (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.

IRC § 317(a) defines the term "property" as meaning "money, securities, and any other property, except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)."

"Subpart-F income" is defined in IRC § 952. Without going through the torturous statutory definition in detail, in summary, Subpart-F income can be described as the sum of the earnings and profits of controlled foreign subsidiary companies of a U.S. parent, plus certain other amounts including bribes, kickbacks, or other proscribed payments made by or on behalf of the corporation, and other items, none of which are involved in this case. To avoid double taxation, IRC § 959 provides that the earnings and profits of foreign subsidiaries paid out as dividends are excluded from gross income of the parent corporation when the foreign subsidiaries actually distribute their pre-taxed earnings and profits in the form of dividends.

Taxpayer's first argument fails because Subpart-F income does not fit within the definition of a "dividend" contained in IRC § 316 (a). At the time Subpart-F income is calculated for inclusion in the U.S. parent's gross income, it does not involve a "distribution of property" as that term is defined in IRC §§ 316 and 317. In fact, there is no distribution of anything, let alone, money, securities or property of any kind. If the U.S. Congress had intended the definition of a "dividend" to include Subpart-F income they would have amended the definition in IRC § 316 (a) to say so. It is apparent from the language of the Internal Revenue Code that dividends, defined in IRC § 316 (a), and Subpart-F income, defined in IRC § 952, are two different statutory concepts.

A situation identical in all relevant parts to this case was involved in Kraft, Inc. v. Sweet, 213 Ill. App. 3d 889 (4th Dist. 1991). In that case Kraft claimed a subtraction modification for the Subpart-F income it reported on its federal income tax returns. 213 Ill. App. 3d at 891. The Department disallowed the modification and the taxpayer paid the tax under protest and filed suit under the State Officers and Employees Money Disposition Act, Ill. Rev. Stat.1987, ch. 127, ¶ 170 *et seq*., now 30 ILCS 230/1 *et seq*. Kraft filed a motion for summary judgment on the Subpart-F income issue which was granted by the circuit court. 213 Ill. App. 3d at 892.

The appellate court reversed the circuit court holding that, for the years at issue, which were prior to 1988, Subpart-F income was not a dividend and the Act did not allow a subtraction modification for Subpart-F income. Although the taxpayer, in this case, argues that Kraft is factually and analytically distinct from this case. I find that Kraft is consistent with this case.

First, taxpayer tries to distinguish Kraft because of the timing of the distribution of the Subpart-F income in the form of dividends. Taxpayer states that in Kraft, the taxpayer did not receive both cash and Subpart-F income from its CFCs in the same year, whereas in this case the taxpayer did receive cash distributions in the same year that the paying corporation realized Subpart-F income. Whether that distinction exists or not is irrelevant to the question of whether Subpart-F income is a dividend within the meaning of IRC § 316(a). There is nothing in IRC § 316(a) or IRC § 952 that leads to a contrary conclusion.

Taxpayer alludes to a hypothetical situation addressed by the Fourth Circuit in the Kraft case. The court posed the hypothetical as follows:

> For instance, if the subpart-F income here at issue resulted from a loan by a controlled foreign corporation ("CFC") to a group member, as indicated in the Kraft Groups's brief, the following would result: Kraft Group pays Illinois income taxes on that amount in a given year; then, in a future year, when the CFC profits used to make the loan are actually distributed by the CFC to the Kraft Group corporation, no deduction can be taken by that

> corporation because the dividend would not be part of the [Internal Revenue Code] income of the Kraft Group corporation for that year. While only one tax under the [Illinois income tax act] for the distributed income would be incurred, no such tax would have been incurred if the profits had been distributed the year in which the subpart F income was received by the CFC. 213 Ill. App. 3d at 896.

In its opening brief and in its reply brief, taxpayer distinguishes the case at issue from Kraft because "Super Parent Corporation" both included subpart F income in federal taxable income and received cash distributions from its CFCs in the same taxable year." From this the taxpayer draws the conclusion that "If a subtraction modification for subpart F income were disallowed then the result would be to preclude a deduction for that [subpart F] income, even when that income is distributed to the domestic parent in the form of an actual cash dividend. . . .for dividends actually received, but excluded from federal taxable income by virtue of IRC § 959 [4] a taxpayer could never take any deduction."

[4] IRC § 959 sets forth the ordering rules which, in essence, exclude previously taxed earnings distributions from the U.S parent corporations taxable income.

Taxpayer's analysis is correct to the extent that the subpart F income for the years 1984 and 1987 was not distributed in those years. However, it is difficult to understand why a deduction should be allowed for that subpart F income considering the fact that the Act did not provide for a subpart F income deduction for the years in which the subpart F income involved in this case was earned. Furthermore, taxpayer could have avoided this result by having its foreign subsidiaries pay out their subpart F income as dividends on a current pattern during 1984 and 1987. A long standing principal of tax law is that "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one's taxes." [Citations omitted.] Helvering v. Gregory, 69 F.2d 809, 810 (CCA-2, 1934). The corollary to that principal is that any one may so arrange his affairs that he pays more taxes than he would have if he had opted for a different pattern. In this case, taxpayer chose not to have its foreign subsidiaries pay out their current earnings and profits on a current pattern, so it has no valid grounds for complaining about the tax consequences, and taxpayer cites none. Finally, a long standing fundamental principal of tax law is that each year must stand on its own. Hillsboro National Bank v. Commissioner, 460 U.S. 370, 377 (1983). Therefore, the fact that no subtraction modification can be claimed for the subpart F income earned in 1984 and 1987 when it is distributed does not mean that it must be allowed as a subtraction modification in years for which the statute provided no subtraction modification.

Taxpayer also tries to distinguish Kraft from this case by noting that the court in Kraft distinguished Subpart-F income from dividends because, as noted above, Subpart-F income includes in its definition items such as illegal bribes, kickbacks, and certain other types of payment, whereas these items are not included in the definition of dividends. Taxpayer then states that there is nothing in this case indicating that the Subpart-F income of taxpayer's CFCs included these types of payments.

This argument is specious for several reasons. First, there is nothing in the Kraft decision to indicate that any bribes, kickbacks, *etc*., were involved in that case either, although that is what taxpayer's argument seems to imply. However, even if bribes, kickbacks, *etc*., were a factor in either or both cases, it would not make any difference. The court in Kraft noted the inclusions of bribes, kickbacks, *etc*., in the definition of Subpart-F income to point out the fact that Subpart-F income and dividends are defined differently in the Internal Revenue Code.

Taxpayer's attempt to distinguish Kraft fails because the fact pattern, the issue, and the relevant statutory provisions in Kraft are identical to the fact pattern, the issue and the relevant statutory provisions in this case. Kraft is controlling, so the decision in this case must be the same. Taxpayer is not entitled to the subtraction modifications it claimed for Subpart-F income.

Next, taxpayer argues that taxation of the Subpart-F income by Illinois as apportionable business income violates the due process and the foreign commerce clauses of the U.S. Constitution. Taxpayer cites Japan Line, Ltd. v. Los Angeles, 441 U.S.434 (1979) and Barclay's Bank PLC v. Franchise Tax Board, 114 S.Ct. 2268 (1994) in support of that proposition. In Japan Line, Ltd. the U.S. Supreme Court declared a California *ad valorem* property tax on Japanese shipping containers to be in violation of the foreign commerce clause of the U. S. Constitution. Art. I, § 8, cl. 3. The containers were based and registered in Japan. They were subject to property tax in Japan, and they were used exclusively in foreign commerce. This case is distinguishable from that case because it involved instrumentalities of foreign commerce, the containers. 441 U.S. at 446. There are no instrumentalities of foreign commerce involved in this case and the Illinois Income Tax is not an *ad valorem* tax.

Barclay's Bank Plc., involved California's worldwide combined reporting scheme for calculation of its franchise tax based on net income. Taxpayer states that in that case the U.S. Supreme Court "held that the risk of multiple international taxation created by a state tax is impermissible if multiple taxation is inevitable, and there are no alternatives reasonably available to the taxing state which would eliminate the risk of double taxation." Taxpayer then notes that the Subpart-F income was subjected to multiple double taxation because it was taxed on an unapportioned basis in the foreign countries of its origin and again by Illinois because of its inclusion in the taxpayer's apportionable income. From this scenario, the taxpayer concludes that, for the years at issue, including the Subpart-F income in taxpayer's apportionable income violates the foreign commerce clause because it results in multiple taxation.

Taxpayer has misconstrued the court's holding in Barclay's Bank Plc. Referring, with approval, to its earlier decision in Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983), upholding the constitutionality of the California tax, the court stated, "But Container Corp.'s approval of this very tax, in the face of a multiple taxation challenge, did not rest on any insufficiency in the evidence that multiple taxation might occur; indeed, we accepted in that case the taxpayer's assertion that multiple taxation in fact had occurred." 463 U.S. at 318. Therefore, the fact that the Subpart-F income in this case has been taxed in the foreign countries of its origin does not prohibit Illinois from taxing it again as long as the Illinois tax passes constitutional muster.

The U.S. Supreme Court prescribed a four-pronged test to determine if a state's taxation of interstate commerce passes constitutional muster. To pass constitutional muster, the taxpayer must have sufficient activity within the state to justify the imposition of the tax, the tax must be fairly related to the benefits provided by the state, the tax cannot discriminate against interstate or foreign commerce and it must be fairly apportioned. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). In the instant case, there is no evidence in the record indicating that taxpayer has insufficient activity in Illinois to prohibit the imposition of the tax, or that the tax is out of proportion to the benefits obtained. Illinois is not attempting to tax an unapportioned share of taxpayer's Subpart-F income as argued by the taxpayer. The income is apportioned by the statutory three-factor formula utilizing the percentage of sales, property and payroll in Illinois to sales, property and payroll everywhere. Thus, the income is fairly apportioned and there is nothing in the record to show that it discriminates against interstate or foreign commerce. Simply because the Subpart-F income has been taxed in foreign countries does not mean it cannot be taxed again by a state income tax that passes constitutional muster. Container Corporation of America v. Franchise Tax Board, *supra*. As the Department states in its brief, taxpayer's reliance on Barclay's Bank Plc., *supra*, and Japan Line, Ltd., *supra*, is misplaced.

Next, taxpayer argues that by including the Subpart-F income in apportionable income, the Department violates the U.S. Supreme Court's ruling in Kraft General Foods Inc. v. Iowa Department of Revenue and Finance, 505 U.S. 71 (1992). In that case the

U.S. Supreme Court held that Iowa's corporate income tax violated the foreign commerce clause because it treated dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries.

The Iowa statute at issue in Kraft General Foods, Inc., followed the federal scheme for determining a corporation's taxable income. 505 U.S. at 73. The Iowa statute did not tax an apportioned share of the combined income of a unitary business consisting of a parent and one or more subsidiaries. 505 U.S. at 74 [n. 9]. Iowa's scheme required separate income tax returns from related corporations doing business in the state. As is permitted in calculating federal taxable income, Iowa allowed a deduction for dividends received by a corporation from domestic subsidiaries. 505 U.S. at 74. Iowa did not allow a deduction for dividends received from a foreign subsidiary doing business outside the United States, however. *Id.* Under this scheme, the dividends of the foreign subsidiary were subject to tax in the parent corporation's income, but the dividends from the domestic subsidiary were not subject to tax. Iowa did not tax the income of domestic subsidiaries unless they conducted business in Iowa. *Id.* The Court held that this scheme discriminated against foreign commerce in violation of the foreign commerce clause of the U.S. Constitution, Article I, § 8, cl. 3.

There is no such discrimination in the instant case. For the years at issue, the Illinois Act required unitary groups, such as the taxpayer and its subsidiaries, to calculate their income tax liability on a combined basis. Under this method the tax of each member of the unitary group is based on its apportioned share of the income of all of the members of the unitary group excluding foreign corporations that do not do their business in the United States. Caterpillar Financial Corp. v. Whitley, 288 Ill. App. 3d 389 (3rd Dist. 1997).

During the years at issue, the income of the domestic subsidiary was included in the taxable income of the unitary group that was apportioned to Illinois. The income of the foreign subsidiary corporations, the earnings of which made up the Subpart-F income in question, was also included in the taxable income of the unitary group because, as Subpart-F income, it was included in the federal taxable income of their parent corporation. Then, the combined income was apportioned according to the three-factor formula. Dividends paid by the subsidiary corporations, both domestic and foreign were excluded from the Illinois apportionable tax base. The income from the foreign subsidiaries was not treated any less favorably than that of the domestic subsidiaries. Therefore, there was no discrimination against foreign commerce.

Wherefore, for the above reasons, the Notices of Deficiency should be made final.

ENTER: August 8, 1999

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Administrative Law Judge